



Japanese Financial Liberalization: Economic and Political Dimensions

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A Research Paper

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A Research Paper

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Japanese Financial Liberalization: Economic and Political Dimensions

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Overview

*Information available
as of 2 October 1984
was used in this report.*

Japanese financial markets have been highly regulated for most of the postwar period, with the government dictating the scope of activities for intermediaries and strongly influencing the cost of credit to borrowers and the extent of capital flows. The tightly controlled financial system was initially designed to ensure that relatively scarce personal savings were channeled to business firms at the lowest possible cost to encourage rapid investment and economic development.

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An increase in personal savings coupled with a decline in the need for investment following the 1973-74 oil crisis destroyed much of the system's rationale and led some Japanese—including the central bank—to press for financial deregulation. The Finance Ministry's response to these initial pressures, however, was narrowly focused and piecemeal. Progress was concentrated in short-term money markets, where interest rates were decontrolled, and in international transactions. As US financial deregulation picked up speed in the latter half of the 1970s, many analysts began to focus on the possible economic ramifications of Japan's less ambitious liberalization program. Some charged that Japanese companies benefited handsomely from regulations that kept the country's growing pool of savings at home, keeping interest rates—and thus production costs—low, and thereby permitting Japanese firms to undercut foreign competitors' prices.

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The mushrooming of Japan's current account surplus since 1981 has heightened foreign concern over Tokyo's financial regulations. Some US observers argue that these controls have kept the yen from appreciating and hindered the recycling of Japan's huge foreign trade surpluses. Pressure from Washington, which culminated in last spring's bilateral yen-dollar working group meetings, has focused Japanese attention on these problem areas. Tokyo has promised additional movement on financial market liberalization, including the removal of most restrictions on interest rates within two to three years. To promote yen internationalization, the Japanese Government has pledged to create new Euroyen markets, where yen transactions can be conducted freely outside of Japan.

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We believe domestic factors, as well as international pressure, will compel Japanese authorities during the remainder of the decade to accelerate the pace at which they deregulate the financial system although bureaucratic obstacles will continue to block abrupt liberalization:

- The volume of internal government debt that is maturing will jump beginning in 1985, straining the financial system as it now exists and perhaps leading to the removal of remaining interest rate regulations.

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- Once begun, liberalization in Japan, as in other countries, feeds upon itself. Losers from past deregulation are already demanding compensation in the form of liberalization in an area of their choice.

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We believe US observers frequently fail to recognize the full extent of past liberalization. Hence, they tend to overstate the impact removal of remaining financial regulations will have on Japanese competitiveness. We doubt that future reform will do much to narrow Japan's global trade surplus or its surplus with the United States:

- We are skeptical that further financial liberalization will erase the alleged Japanese competitive advantage derived from low interest rates. As a result of the deregulation of money markets in 1978-79 and the liberalization of foreign exchange controls in 1980, Japanese real interest rates are now largely in line with those prevailing elsewhere. Moreover, we believe it unlikely that borrowing costs for companies will rise further as decontrol progresses. Future deregulation should heighten competition among Japanese banks and thus restrain them from passing along higher funding costs. Additionally, the nonbank financing options of Japanese corporations will expand.
- We believe analysis forecasting an appreciation of the yen as liberalization reaches its maximum has merit but should not be pushed too far. Financial markets are expected to deepen and accommodate a greater volume of transactions as deregulation progresses, making them more attractive to foreign institutional investors. Unless accompanied by a rise in Japanese real interest rates relative to those prevailing elsewhere, however, this development will have only a minor impact on the yen. Given the current freedom of capital flows, real interest rates in Japan do not diverge much from those prevailing elsewhere.
- Although we doubt future financial liberalization will do much to alter corporate financing costs or the value of the yen, we feel reform has many positive aspects. Chief among them is the ongoing expansion of foreign access to yen capital markets. This allows foreigners, including US corporations, to reduce risks by diversifying the currency composition of their borrowings. Although the cost of yen financing in real terms may not be especially low, in nominal terms it is. Low nominal interest rates are expected to continue, as low inflation and high savings seem entrenched in Japan.

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iv

Contents

	<i>Page</i>
Overview	iii
The Environment for Change	1
The Japanese Financial System	1
The Finance Ministry: Wedded to Gradual Liberalization	5
The Domestic Challenges to MOF Conservatism	7
The Dynamics of Liberalization	9
Progress and Remaining Problems	11
Short-Term Money Markets	11
Japanese Securities Markets	13
Capital Flows Into and Out of Japan	15
Internationalization of the Yen	17
Implications of Financial Liberalization	19
Domestic Economic Ramifications of Liberalization	19
International Economic Implications of Deregulation	21
The Political Dimensions of Liberalization	23

Appendix

Japan: Chronology of Financial Liberalization Measures	25
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Japanese Financial Liberalization: Economic and Political Dimensions

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The Environment for Change

The Japanese Financial System

After World War II the Japanese Government molded the country's financial system to foster a high level of investment and rapid economic growth. The Ministry of Finance (MOF) implemented sweeping regulations to ensure that personal savings were channeled to business firms at the lowest possible cost. The financial authorities controlled:

- *The availability of credit.* The government, believing indirect financing from bank loans (rather than direct financing through stocks and bonds) was the most efficient way to fund corporate investment, made sure large banks got sufficient funding. In the immediate postwar period, these institutions were in turn directed to give preference to loan requests from basic industries—such as steel—viewed as key to reconstruction efforts.
- *The cost of credit.* Financial authorities stabilized nominal interest rates on corporate borrowing from banks, at times at artificially low levels. To reduce bank funding costs, interest rates on deposits were kept below market levels, and households were offered tax incentives to save.
- *The scope of operations of financial institutions.* As in the United States, banks were prohibited from handling securities transactions. In Japan, moreover, bank functions were specialized. For example, regional banks looked after the financing needs of farms and small businesses, while long-term credit banks and city banks—commercial banks on a national scale—filled the needs of large businesses.
- *Capital flows into and out of Japan.* Such flows were generally prohibited to prevent balance-of-payments problems. This restriction also provided valuable insulation for the nonmarket aspects of the regulated financial system.

The highly regulated financial system achieved its primary goal: corporate investment in plant and equipment grew an average 16 percent annually during the 1960s. The system, nonetheless, had its drawbacks. Banks tended to:

- Form such close ties to individual businesses that they lent excessive amounts to longtime clients, resulting in overinvestment in steel, petrochemicals, and textiles.
- Require borrowers to deposit over 20 percent of their loan proceeds as compensating balances, undermining in part the government's efforts to keep interest rates low (see figure 1).

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The 1973-74 oil shock, which ended double-digit GNP growth in Japan, destroyed much of the rationale for the highly regulated system. Many past proponents of the status quo became advocates of a more market-oriented system:

- As growth prospects dimmed for capital-intensive heavy industry, the private sector's need for low-cost investment loans declined, and its need for high-yielding financial assets in which to invest surplus funds became increasingly important.
- The Bank of Japan found its traditional monetary policy tools, which had emphasized bank access to credit, lost much of their relevance as loan demand slackened relative to the supply of savings (see figure 2).

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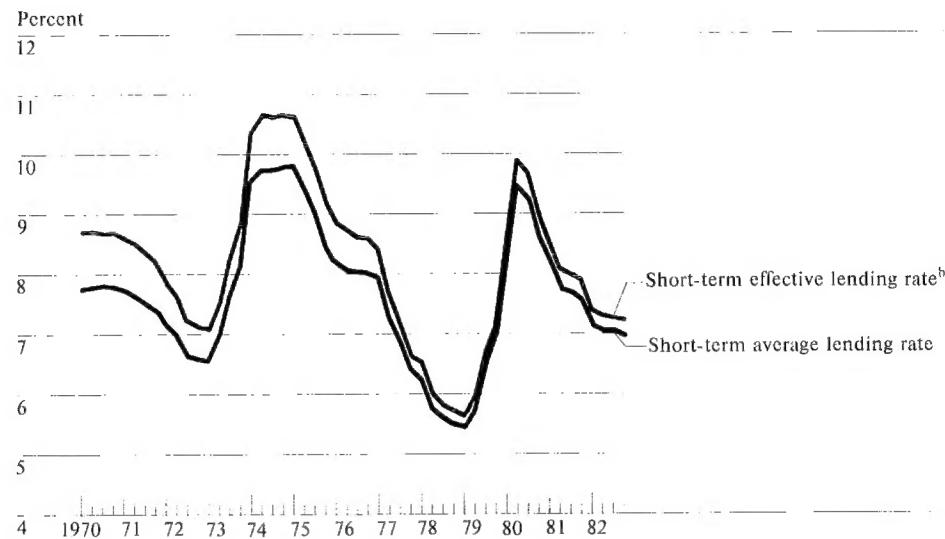
The Finance Ministry's response to initial pressures for a freeing of financial controls was narrowly focused and piecemeal:

- Short-term money markets were deregulated in a step-by-step fashion, enabling the Bank of Japan to deemphasize credit availability and instead to influence interest rates in the open market.

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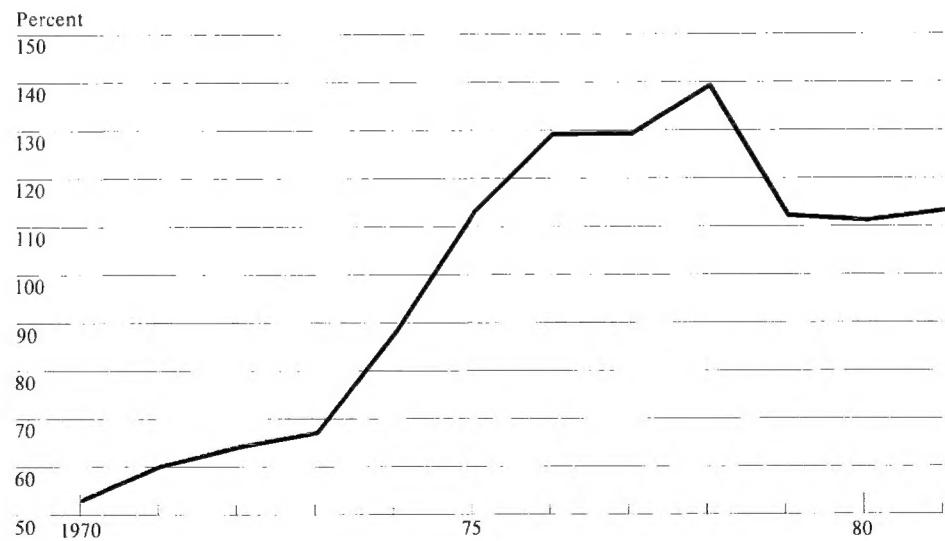
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Figure 1
Japan: Nominal and Effective Interest Rates, 1970-82^a

^a Quarterly data.^b Includes effect of compensating balances.

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Figure 2
Japan: Household Savings as a Share of Corporate Investment, 1970-81



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- Because of the concerted go-slow effort, residual restrictions remain, limiting both the access to certain markets and the rate of return available on some assets. [redacted]

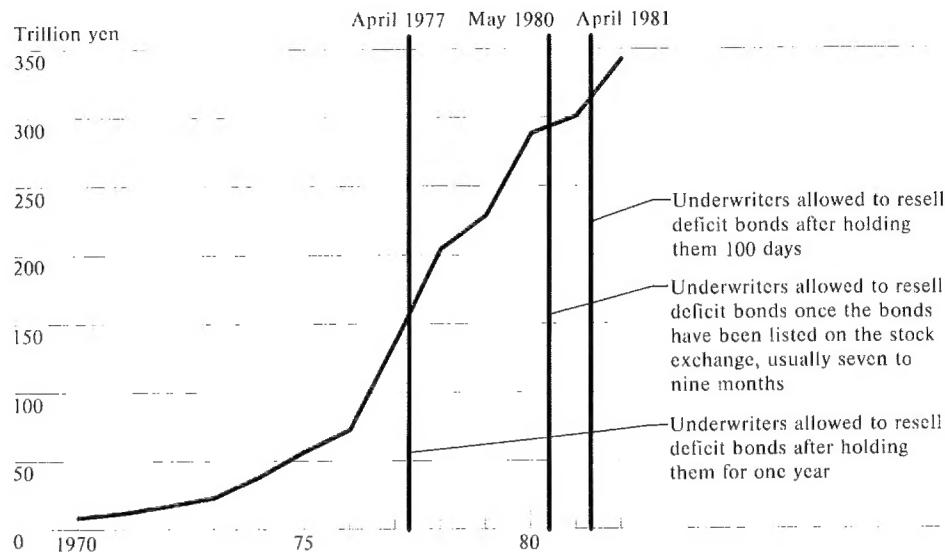
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Foreign critics claim the remaining regulations cause a variety of economic ills and therefore question the Finance Ministry's gradual approach to liberalization:

- As the size of Japan's current account surplus has grown, so have concerns about how financial regulations might retard or distort efforts to invest these surplus funds abroad.
- The existence of controlled interest rates on deposits raises questions about the competitive advantage Japanese firms may enjoy because of lower capital costs.
- Underdeveloped money markets are a legacy of past and present regulations and of the dominance of indirect financing during the high growth era. Critics claim this underdevelopment, which reduces the attractiveness of yen assets to institutions whose large investments could swamp thin markets, is an obstacle to long-term strengthening of the Japanese currency. [redacted]

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Figure 3
Japan: Volume of Secondary Bond Market
Transactions, 1970-82



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Table 1
Japan: Ministry of Finance Bureaus
Involved in Liberalization Debates

Bureau	Director General ^a	Responsibilities	Comments
Budget	Yoshihiko Yoshino	Prepares and monitors government budget	Committed to reduction of budget deficit. Opposed to measures that would raise government debt service costs, such as market-determined bond yields.
Financial	Yasutaka Miyamoto	Administers central government borrowing	Would like to improve the attractiveness of government bonds to general public by expanding diversity and responsiveness to market forces.
Banking	Masateru Yoshida	Regulates banks and insurance companies	Has key say in major liberalization moves. Generally favors gradual deregulation as long as measures do not harm weaker institutions.
Securities	Toru Sato	Regulates securities industry	Probably willing to see liberalization proceed more quickly than Banking Bureau because its constituency—securities industry—likely to fare well in freer environment.
International finance	Toyoo Goyen	Administers financial dealings with other countries	Viewed as most pro-deregulation. Has frequently liberalized Japanese banks' overseas operations when decontrol at home politically unacceptable.

^a Reports to Minister of Finance, Noboru Takeshita.

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The Finance Ministry: Wedded to Gradual Liberalization

The Ministry of Finance, which has primary responsibility for shaping the Japanese financial system, is becoming sensitized to foreign concerns about financial regulations. We believe, nonetheless, that domestic pressures continue to guide MOF decisions on the pace of financial reform. [redacted]

In the upper echelons of the Ministry, advocates of gradual liberalization predominate, with those favoring faster action a vocal minority and with only a few opposed to any further financial changes:

- Press reporting indicates Finance Minister Take-shita favors gradual liberalization; so do the Ministry's Securities and Banking Bureaus.
- Officials in the International Finance Bureau, the newest and thus the least powerful of the Ministry's seven bureaus, are less conservative. [redacted]

MOF support for a go-slow approach stems partly from a fear that deregulation will cause a decline in Ministry prestige and power. Concerns about investor protection reinforce this preference for gradualism. Japan still lacks many of the policing agencies found in the United States, such as the Securities and Exchange Commission. [redacted]

In defending the gradual approach, Ministry officials also point to the opposition of the politically powerful postal savings system and to the possibility that liberalization would boost the cost of servicing government debt. We believe the importance of these obstacles has been overstated. During the past five years, the Ministry has endorsed—or at least acquiesced in—changes that have eroded some of the traditional fundraising advantages of the postal savings system and the central government:

- The postal savings system has sufficient political backing in the Liberal Democratic Party (LDP) to stall attempts to abruptly end its privileged position

in the financial arena¹ but has not been able to prevent gradual erosion of its near monopoly on personal savings. The MOF has begun to approve new types of financial assets with rates of return competitive with those offered on postal savings accounts. In January 1980, for example, the Ministry allowed securities houses to offer mutual funds that invest in medium-term government bonds.

- The Ministry's ability to keep yields on primary issues of government debt low enough to make a dent in government interest expenses has waned in recent years as the secondary bond market has grown (see figure 3). With increasing frequency, the syndicate of banks and securities houses that underwrites over one-third of the government debt has refused to sustain losses by accepting new issues at below-market rates. [redacted]

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We believe the most important source of Ministry conservatism is its close ties to the institutions it regulates:

- Frequent administrative contact has cemented these ties. Employees from major banks and securities houses, moreover, often serve rotational assignments at the Ministry, and retired Ministry officials frequently become executives at private banks.
- When combined with the MOF's internal division of responsibilities, these ties have created powerful advocates for the protection of both weak and strong institutions (see table 1). Banking Bureau loyalties, for example, are torn between institutions that are likely to fare well in a more competitive environment—such as the city banks—and those that probably would not—such as mutual savings and loan banks, which are already suffering from a secular decline. [redacted]

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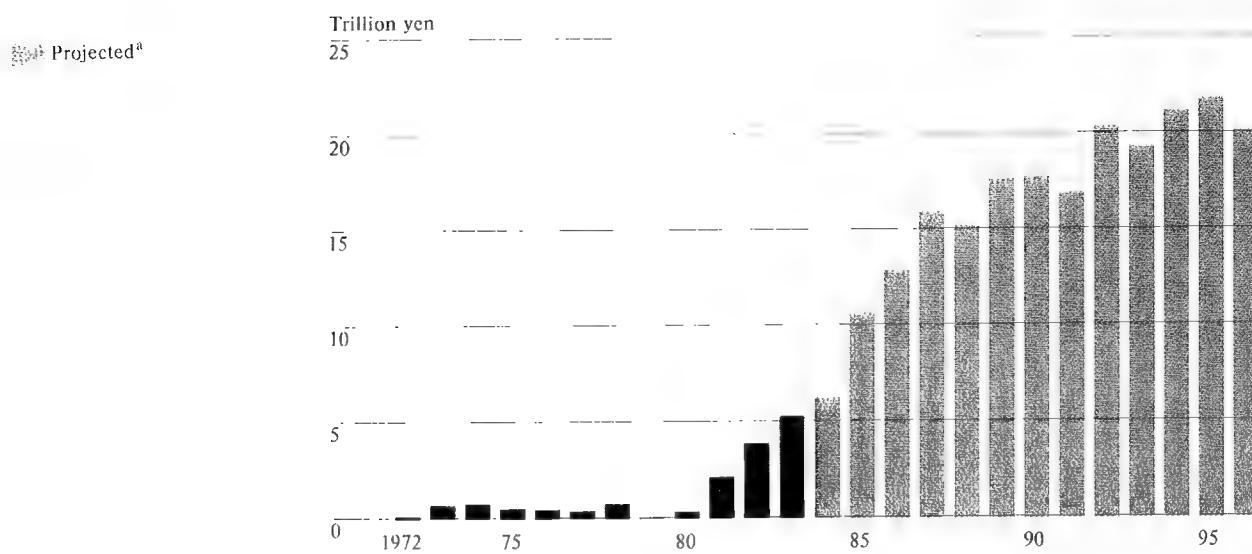
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¹ The Ministry of Posts and Telecommunications has not made post offices curtail abuses of tax-free personal savings accounts, whereas the Ministry of Finance has forced banks to strictly enforce regulations concerning such accounts. [redacted]

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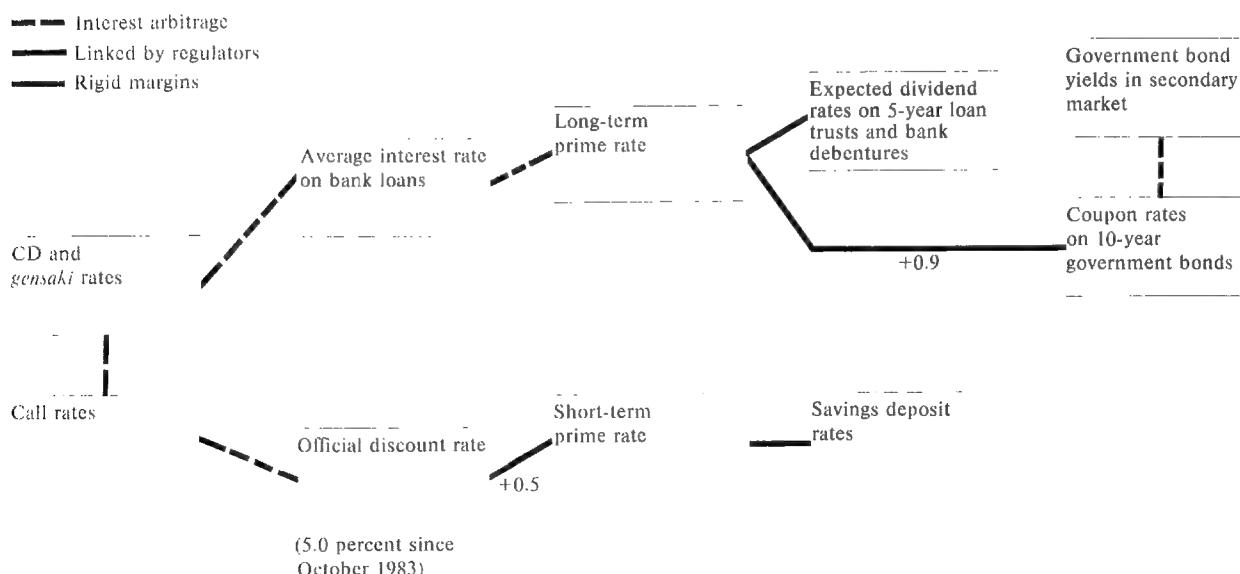
Figure 4
Japan: Government Bond Redemptions, 1972-96



^a Assumes budget deficit will be reduced 1 trillion yen annually beginning in JFY 1986. Also assumes 6.6-percent yields on government bonds.

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Figure 5
Japan: Interest Rate Structure



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The Domestic Challenges to MOF Conservatism

Although few in Japan question the wisdom of phased deregulation, criticism of the Finance Ministry's slow pace of reform is growing. Some of the opposition has been relatively easy to defuse—such as that originating in the press—but economic pressures for change are building, making it increasingly difficult for the Ministry to drag its heels on deregulation. [redacted]

The US-Japanese yen-dollar talks in the first half of 1984 ignited a flurry of press comment in Tokyo on liberalization issues, much of it critical of the Ministry's go-slow strategy:

- After the April meeting of the bilateral working group, an editorial in the respected *Asahi* claimed that, in setting the time frame for liberalization, the Finance Ministry was placing too much emphasis on protecting banks and too little on the needs of business firms and the general public.
- We believe the Finance Ministry, as the most influential of all ministries in Japan, has sufficient clout to slough off such press criticism. [redacted]

Strong pressure for speedier liberalization from Prime Minister Nakasone and other high-ranking LDP politicians has not materialized:

- Although Nakasone cajoled the Ministry into ensuring progress during the yen-dollar talks, we doubt he will force the MOF to abandon its gradualism. [redacted]

- Political leaders in Japan have willingly handed over responsibility for recommending deregulation strategy and timing to MOF advisory panels.
- If financial issues become more politically charged, we believe reform is as likely to slow as to accelerate. The LDP has close ties to financial institutions that cater to farmers and small businessmen; these institutions are expected to fare poorly in a market-oriented financial system. [redacted]

As in the past, the Ministry of Finance has only limited latitude to ignore economic forces pushing for deregulation:

- Massive 10-year government debt issues, made following the first oil crisis to cover revenue shortfalls and to stimulate the economy, begin maturing in fiscal year 1985² (see figure 4). If refinancing of these bonds is to proceed smoothly, the government must introduce new flexibility into funding methods and issue terms. 25X1
- If interest-rate ceilings on deposits are not lifted soon, the funding capacity of banks may be threatened. As short-term instruments with yields freely determined in the secondary market, government securities approaching maturity will be attractive alternatives to time deposits in banks. 25X1
- Wage gains have been moderate in recent years, increasing the importance of interest as a component of personal income. We expect this trend to lead individuals to demand better access to market-rate investments, especially if the government curtails abuses of tax-exempt small savings accounts. 25X1

Members of the financial community are also challenging the Ministry's slow pace of reform. According to the press, most financiers are convinced that sweeping liberalization is inevitable, if not imminent. To prepare for the deregulated environment of the future, bankers and brokers are urging that the Ministry permit them to expand the range of services and market-rate instruments they offer: 25X1

- In May, for example, mutual savings and loan banks requested MOF permission to become regular commercial banks. As savings and loan banks, only 20 percent of their loans can go to big companies. 25X1

² The Japanese fiscal year begins on 1 April. [redacted] 25X1

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Table 2
Japan: Domestic Funding and Clientele
of Financial Institutions

Institution	Domestic Fundraising ^a	Domestic Clients	Comments
City banks	Individual and corporate deposits, with maximum maturity of two years. Money markets.	Large businesses. Individuals get about 10 percent of loans.	Highly leveraged and funding base narrowing. Underwriting of government debt squeezing profitability.
Trust banks	Loan trust certificates, with two- and five-year maturities.	Historically heavy industry, but more emphasis on service industry.	Future rosy if they, along with life insurance companies, can retain exclusive rights to manage pension funds.
Long-term credit banks	Five-year bank debentures. Deposits from corporate clients and government.	Capital-intensive industry.	Growth prospects have dimmed as corporate investment needs have fallen.
Regional financial institutions	Deposits of up to three years' maturity.	Cash-short city banks. Small and medium-size businesses.	Ample funding but poor growth prospects.
Securities houses	Brokerage fees chief source of income.	Industry.	Good growth prospects, but many smaller firms troubled.
Insurance companies	Sales of insurance.	Industry, concentrating on long-term, fixed-rate loans.	Aging of population will improve growth prospects.

^a Approximately 80 percent of bank funding comes from deposits whose interest rates are regulated.

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The Dynamics of Liberalization

The strength of the challenge to the existing Japanese financial system varies by issue. Like the various bureaus in the MOF, specific financial institutions may support liberalization in one area only to oppose it in another. Differences in funding bases and clientele account for this inconsistency (see table 2). For example, city banks would like to expand their fundraising options, specifically by gaining permission to issue five-year bank debentures. They oppose the introduction of commercial paper, however, fearing it would allow securities companies to lure away their loan customers. [redacted]

Intraministerial and intraindustry differences frequently immobilize the policymaking process. When severe financial strains develop within the economy, however, the importance of these differences is reduced, allowing liberalization to proceed:

- Rising interest rates tend to highlight strains within the financial system and to jar loose the policymaking process, permitting partial liberalization to occur. [redacted]

Once begun, liberalization in Japan, as in other countries, has fed upon itself. Losers from deregulation in one area have sought compensation in the form of liberalization in another area. In the United States, for instance, when the advent of money market funds threatened the funding base of savings and loan institutions, savings and loan groups lobbied for the removal of interest-rate ceilings on savings accounts. [redacted]

In Japan the events following the advent of medium-term government investment (*chukoku*) funds in 1980 show a similar pattern of liberalization begetting further liberalization. These *chukoku* funds, introduced to relieve some of the burden placed on financial institutions underwriting government debt issues, became the highest yielding assets within reach of individual investors. The fundraising capacity of the leading securities firms, with exclusive right to handle these funds, increased as a result of their attractiveness. On the other hand, the funding base of other syndicate members declined. To redress this situation, trust banks and long-term credit banks obtained MOF permission in 1981 to offer accounts with

competitive rates. In October 1983 city banks got into the act by offering new high-yielding instruments, which combined a 10-year government bond fund with a 10-year time deposit. [redacted]

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This natural unraveling process helps explain why the pace of financial liberalization in Japan is accelerating despite bureaucratic obstacles:

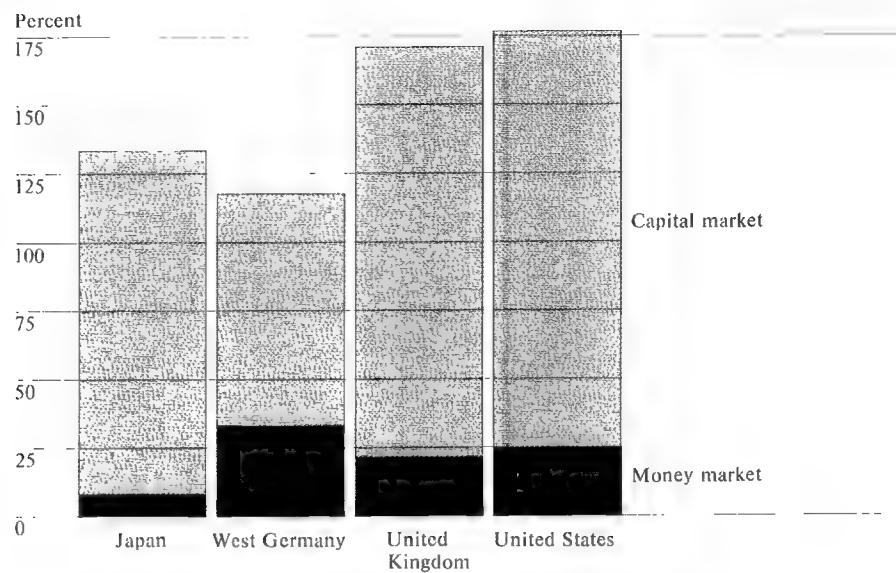
- Feedback from past deregulation is creating pressure for further reform. Furthermore, the expanded freedom the MOF has given Japanese financial institutions in international dealings in recent years is now generating pressure for similar leeway at home.
- We believe the method in which the regulated system unravels will be shaped by the vested interests of bureaucrats and politicians. Feedback from past liberalization will be allowed to proceed unhindered in areas—such as deregulation of interest rates on large deposits—that do not harm key LDP or MOF constituencies. On the other hand, we believe fundamental reform of the corporate bond market—which could lead to a large-scale shift of business from banks to securities houses—will be slow in coming.
- The MOF probably will be allowed to pursue phased deregulation in the future, but the pace at which liberalization measures are introduced no doubt will be stepped up. [redacted]

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Figure 6
Selected OECD Countries: Capital and Money Market
Balances as a Share of GNP, Yearend 1983



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Table 3
Japan: Money Market Instruments

Instrument	Maturity	Minimum Denomination (million yen)	Balance (as of 30 April 1984) (trillion yen)
<i>Gensaki</i>	One to 364 days	100	4.1
Certificate of deposit	Three to six months	300	7.3
Call money	Half day to one month	1, by custom	5.1
Bill discount	One to four months (latter by custom)	10	6.2
Short-term government securities ^a	Usually 60 days	1	16.3

^a Includes treasury bills, food bills, and foreign exchange bills.
 Most bills are held by the Bank of Japan and various government trusts.

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Progress and Remaining Problems

Short-Term Money Markets

Liberalization issues vary from one type of financial market in Japan to another, as do the prospects for significant deregulation in the near future. [redacted]

Short-term money markets in Japan, as elsewhere, allow corporations and financial institutions to dispose of—or acquire—temporary liquidity to adjust for seasonal and geographic funding needs. Instruments with competitive rates of return must be offered in a wide variety of maturities and denominations to meet participants' differing needs (see table 3). By definition, money markets only handle assets with maturities of less than one year. [redacted]

As the focus of the government's first efforts to deregulate interest rates, Japanese short-term credit markets generally offer competitive yields:

- Until the late 1970s only yields in the *gensaki* market—where long-term bonds with attached repurchase agreements are traded—were freely determined. *Gensaki* yields are still considered the most representative short-term rates in Japan.
- Rates in the call and bill discount markets, where Japanese banks receive and extend each other short-term financing, were deregulated step by step from 1977 through 1979. Central bank open-market operations, however, continue to influence rates available in these markets. [redacted]

Although interest rates move flexibly in existing money markets, problems regarding terms of issue and access remain:

- Only financial institutions are allowed to participate in call and bill discount markets. Direct deals by firms and individuals would increase the market competitiveness.
- Certificates of deposit (CDs) are not considered negotiable securities in Japan, and a secondary market was not permitted to develop until April 1982. [redacted]

The major defect of Japanese money markets, according to most experts, is the narrow range of instruments available, which has kept the market small by international standards (see figure 6):

• We believe the lack of a viable market in short-term government debt instruments (in particular, treasury bills) is the most serious shortcoming. Unlike their US counterparts, Japanese treasury bills are sold only for stopgap funding. The Finance Ministry, moreover, fixes yields on these securities below market levels. The Bank of Japan thus incurs a loss when it sells them to call market brokers. 25X1

• Business firms in Japan are not permitted to issue commercial paper. As short-term unsecured promissory notes, commercial paper is considered incompatible with traditional Japanese reliance on collateralized financing. 25X1

• Japan also lacks yen-denominated bankers acceptances, which are negotiable instruments involving bank drafts to pay trade-related financing at maturity. However, Japan's bill discount market is a close substitute, with tacit bank guarantees on payment replacing the formal ones involved in banker acceptances. 25X1

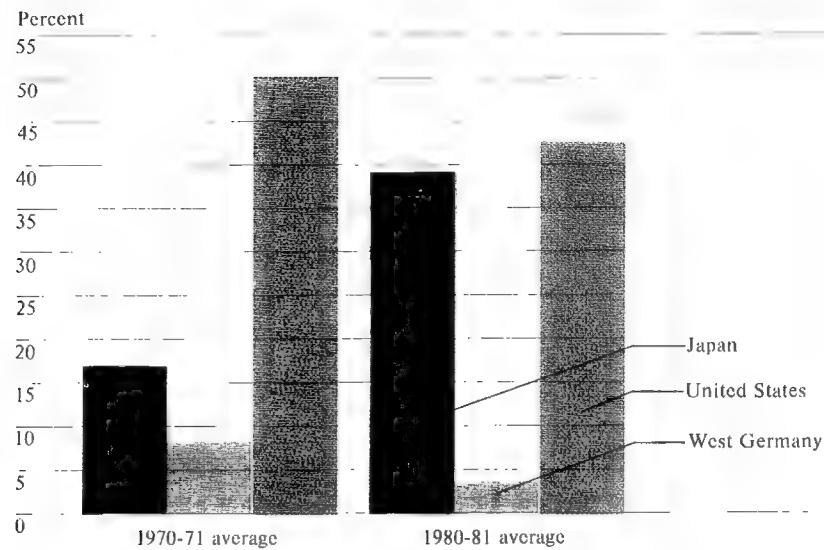
We believe the prospects for filling the gaps in Japan's money markets are good:

• In the final report of the US-Japanese yen-dollar working group in mid-1984, the MOF pledged to inaugurate a yen-denominated bankers acceptance market by 1985. Although many Japanese were initially skeptical that the new market would prove an attractive way to finance foreign trade, by early October almost all financiers there were enthusiastic about its potential, according to US Embassy reporting. 25X1

• To enhance monetary policy effectiveness, the central bank is pushing for a US-style treasury bill market where securities can be freely traded. The Finance Ministry is cool to the idea, claiming the present system is more appropriate. As soaring refinancing needs force the government to diversify its fundraising methods, many Japanese believe MOF opposition will subside. 25X1

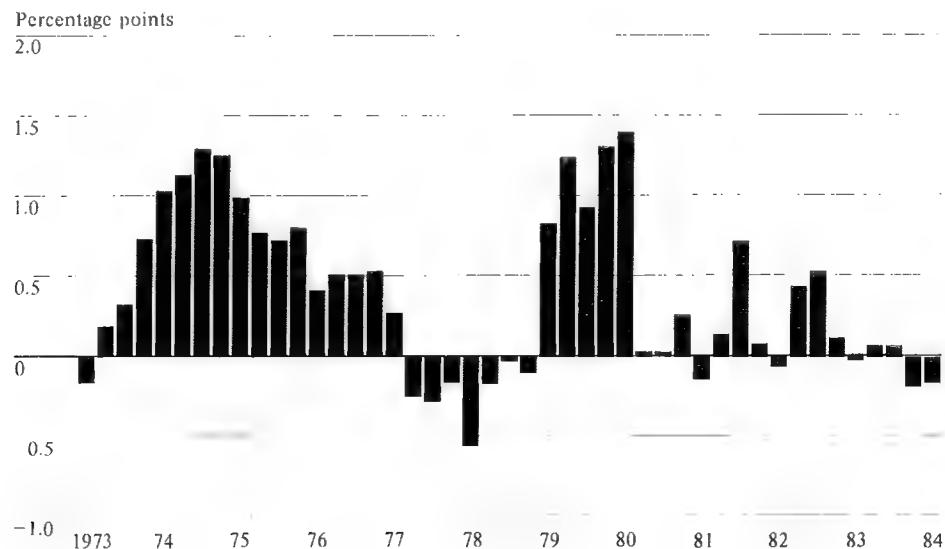
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Figure 7
Selected OECD Countries: Share of Funds That Nonfinancial Sectors Raise Directly in Capital Markets



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Figure 8
Japan: Comparison of Government Bond Yields in Primary and Secondary Markets, 1973-84^a



^a Yields on secondary market of bonds with longest maturity minus yields on new 10-year bond issues. Quarterly data

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Japanese Securities Markets

The government's postwar decision to encourage firms to rely on indirect financing dealt Japanese bond and equity markets a heavy blow. Leery of antagonizing their bankers, companies shied away from investigating nonbank funding sources. As economic momentum slowed in the mid-1970s, the power balance between banks and companies became more equal. Firms felt freer to explore direct financing options, namely, stock and bond issues.

What potential borrowers in Japan's equity and corporate bond market found in the mid-1970s, however, was not particularly appealing (see figure 7):

- Industrial bonds had to be secured by collateral, an especially onerous requirement for leasing and trading companies that possessed only limited amounts of land, factories, and machinery. Japanese companies that floated unsecured bonds overseas, moreover, had difficulty issuing secured bonds domestically without violating provisions of agreements with overseas trustee companies.
- The tradition of giving existing stockholders the right to buy new issues at par value raised the cost of raising funds via equity markets for established companies.

For investors, flaws in Japanese securities markets were equally obvious:

- Yields on primary issues of bonds, especially government ones, frequently carried below-market coupon rates.
- Primary and secondary bond markets were small until the mid-1970s, when the government began using deficit financing. As a result, investors' choices were limited.
- Over two-thirds of the stock listed on the Tokyo Stock Exchange were and still are held by institutional investors, including companies in industrial groups such as Mitsui; these stocks were rarely traded. The shares held elsewhere were viewed as fair game for speculators, and price movements were quite volatile, discouraging individuals from entering the market.

In the past decade, some of these defects have been rectified:

- As indicated earlier, the underwriting syndicate for central government bonds is forcing the Finance Ministry to set yields on new issues close to those prevailing on the secondary market (see figure 8). This development has ripple effects throughout the financial system, as regulators tend to link interest rates.
- In 1979 Sears Roebuck became the first private company to issue totally unsecured bonds in Japan. The eligibility requirements drafted at that time were so stiff, however, that only 11 Japanese companies qualified.
- In FY 1980 par issues accounted for only 8 percent of the new domestic equity issues.

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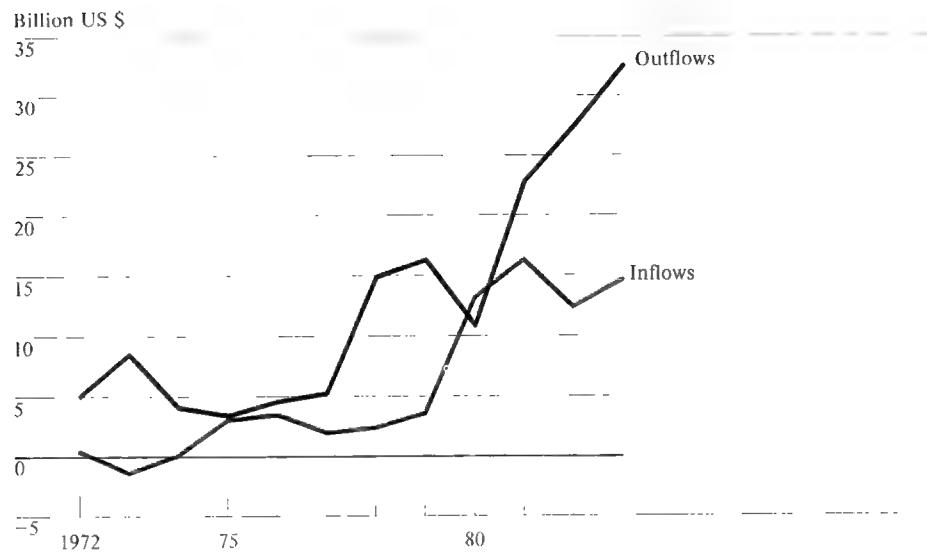
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We believe the power balance between banks and securities companies will determine if remaining deficiencies—particularly those in the corporate bond market—are corrected:

- Banks, especially long-term credit banks, oppose further erosion of the principle of collateralization. Eligibility requirements for unsecured corporate bond issues have been relaxed twice in the 1980s, but banks have used their clout to ensure concessions were minor.
- Securities houses are growing faster than other types of financial institutions in Japan. We believe at least a decade will pass, however, before this trend erodes the banks' political and economic supremacy.

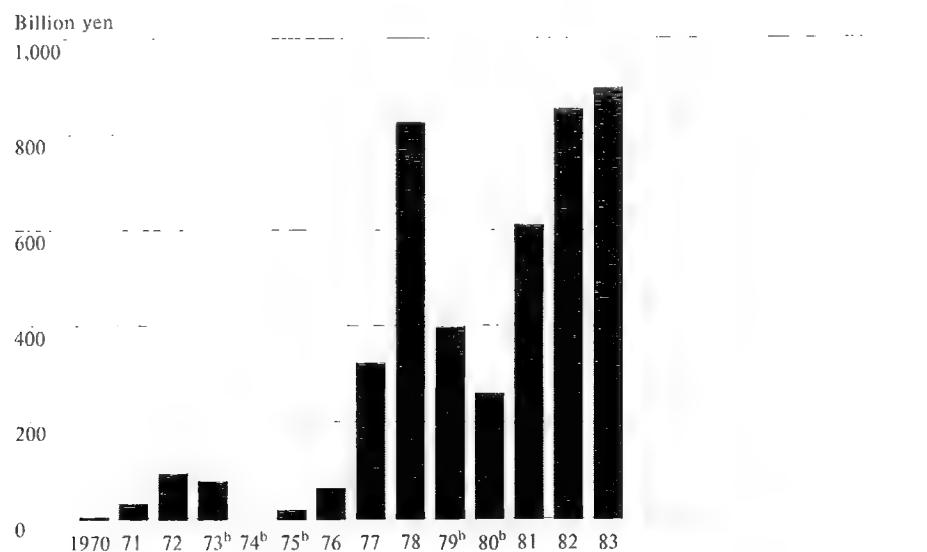
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Figure 9
Japan: International Capital Flows, 1972-83



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Figure 10
Japan: Yen Bond Issues by Nonresidents, 1970-83^a

^a Includes private placements as well as public offerings.^b Years when Japan's current account was in deficit.

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Capital Flows Into and Out of Japan

In its 1949 foreign exchange law, Japan forbade all capital transactions between residents and foreigners without Cabinet approval. The prohibition on capital flows was intended to help control balance-of-payments problems but also provided valuable insulation for the highly regulated financial system. As the economy matured and other industrialized nations began to open their capital markets, Tokyo gradually softened this stricture:

- As a condition for entry into the OECD in 1964, Japan removed bars that had limited the free exchange of yen for other currencies and gold.
- In the 1970s, balance-of-payments considerations periodically inspired the Finance Ministry to liberalize foreign exchange transactions. For example, to attract overseas funds to cover a \$9 billion current account deficit, Tokyo in 1979 allowed nonresidents to participate in the *gensaki* market and in the newly created CD market. [redacted]

In 1980 Tokyo formalized its more progressive attitude toward capital movements by enacting a new foreign exchange law. It made restrictions on external transactions the exception rather than the rule. As a result, capital flows in both directions mounted rapidly (see figure 9):

- Capital inflows quadrupled and outflows doubled from 1979 to 1983. Because outflows started from a much larger base, however, they still exceeded inflows by \$18 billion last year.
- Much of the increase in outflows reflects the desire of institutional investors in Japan to reduce risks by diversifying the currency denomination of their portfolios.
- The growth in the external bond issues of Japanese firms, predominantly in the form of low-interest Swiss franc paper, accounts for much of the rise in inflows. [redacted]

Even after the promulgation of the 1980 law, the Ministry of Finance continued to restrain many types of capital flows through administrative guidance:

- During April-September 1983 the MOF set a \$11 billion cap on medium- and long-term lending by

private Japanese banks to overseas borrowers. We believe this inhibited the efficiency with which the Japanese current account surplus was recycled.

- Japan's current account balance weighs heavily in MOF decisions on the permissible volume of yen-denominated bond issues by foreigners (see figure 10). [redacted]

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Although freedom of capital movements is incomplete, we believe the liberalization that has taken place has effectively integrated Japanese money markets with those abroad. Tokyo, moreover, has shown a willingness to remove some of the remaining barriers to the free flow of funds into and out of Japan:

- Euroyen and *gensaki* interest rates usually move in tandem, indicative of the integration that now exists.
- In March 1984, the Finance Ministry ended its case-by-case screening of banks' offshore medium- and long-term yen loans. Some Japanese journalists doubt this will boost offshore yen lending because they consider the new requirements that the MOF imposed at that time as equally restrictive; these requirements were designed to prevent banks from extending excessive amounts to troubled LDC debtors. In our view, this is a valid concern, but the ease with which Indonesia and New Zealand borrowed record sums of yen over the summer provides some evidence of a genuine liberalization.

- In our judgment, the principle of free capital flows is well enough entrenched that backsliding will be minimal when Japan encounters balance-of-payments problems. [redacted]

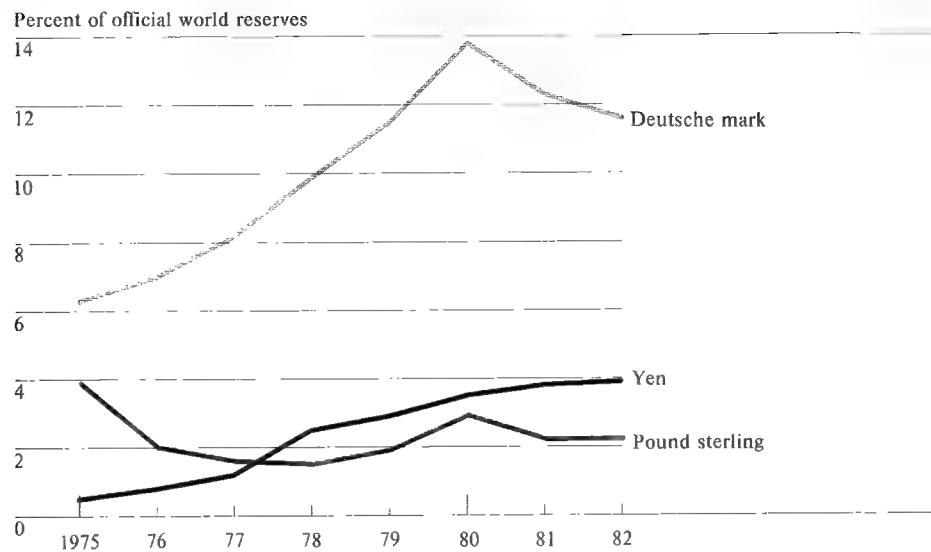
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Figure 11
Use of Mark, Pound, and Yen as Official Foreign
Exchange Reserves, 1975-82



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Table 4
Situation in Euroyen Markets

Market	Status as of 1 September 1984	Prospects for Future Liberalization
Euroyen bond issues by nonresidents of Japan	Only supranational agencies or Aaa-rated governments that have previously floated three samurai bonds are eligible to float bonds.	The MOF is expected to allow governments with lower credit ratings and fewer samurai issues to tap the Euroyen bond market later this year. Foreign companies with similar qualifications—a pool of four at present—are also likely to gain access.
Euroyen bond issues by residents of Japan	On 1 April 1984, 108 Japanese companies were given permission to issue convertible Euroyen bonds; 30 became eligible to issue straight Euroyen bonds.	Future relaxation probably will be tied to improvements in the domestic corporate bond market, such as an easing of heavy collateral requirements and enhanced rewards for being a good credit risk.
Euroyen certificates of deposit (CDs)	Currently prohibited because financial authorities fear Euroyen CDs will compete head-on with domestic CDs in Japan and proceeds might be used to fund long-term Euroyen lending.	This prohibition is slated to be lifted by 1 December 1984. Unlike domestic CDs, ceilings on issues will not be imposed. Proceeds, however, will not be allowed to flow back into Japan. This restriction is designed to minimize negative fallout on the domestic market.
Euroyen loans	Short-term Euroyen lending to nonresidents liberalized in June 1983 and to residents in June 1984. Medium- and long-term lending still prohibited.	The Ministry of Finance is unlikely to grant banks permission to make medium- and long-term Euroyen loans this year, according to press reports. MOF officials fear decontrol would undermine the regulated interest-rate system in Japan.

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Internationalization of the Yen

As Tokyo has become more openminded about capital flows, prospects for yen internationalization have brightened. Even so, the potential for wide international use of the yen as a currency for trade transactions and as a medium for investment remains largely unrealized. Some US observers view internationalization as key to sustained strengthening of the yen.

The share of Japanese trade denominated in yen is rising, although still below the corresponding ratio in other industrial powers:

- Currently 40 percent of Japanese exports are invoiced in yen, up from 33 percent in 1981; this is less than half as high as the share of West German exports priced in marks. The import side of the picture is even more striking: only 3 percent of Japanese imports are yen denominated.
- Financial analysts frequently cite the lack of yen-denominated bankers' acceptances as the cause of the low level of trade conducted in yen. In our view, this argument should not be pushed too far given the existence of a close substitute, namely, the bill discount market.
- We believe the biggest obstacle to enlarging the volume of yen-based trade is the international tradition of pricing raw materials in dollars. These items accounted for over two-thirds of Japanese imports in 1983.

In our opinion, use of yen as a reserve currency is also limited, reflecting in part past Japanese attempts to discourage this form of internationalization:

- Tokyo reversed that policy in 1978, however, and in March 1980 exempted yen deposits of foreign governments from interest-rate ceilings. The Japanese hoped that, by making such deposits more attractive, they would be able to attract the funds of oil exporters to cover the \$11 billion current account deficit (see figure 11).

We believe relaxation of capital controls has had its most profound effect on the yen's use as an investment medium:

- In 1983 the yen replaced the British pound as the second most popular currency in international lending. The yen's 6-percent share paled, however, next to the dollar's 74-percent share. Five percent of foreign bond and Eurobond issues were denominated in yen last year, putting the yen in fourth place—behind the dollar, the deutsche mark, and the pound.

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Further expansion of the yen's role in international finance hinges partly on the creation of free Euroyen markets, where yen transactions can be conducted outside of Japan. Financial authorities in Tokyo so far have been reluctant to allow these markets to develop. They fear uncontrolled growth of Euroyen markets may erode monetary policy control and lead to unregulated risk taking by banks:

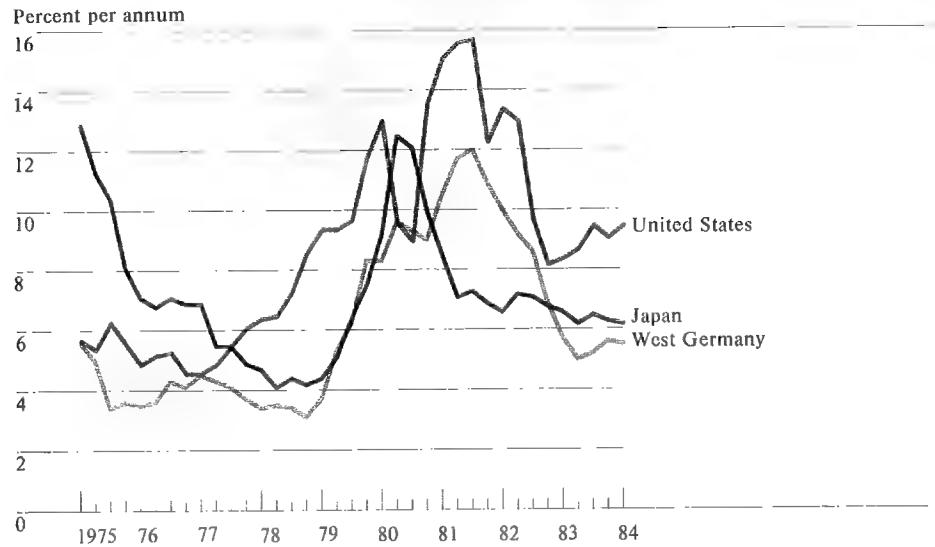
- Despite their apprehension, Japanese officials agreed at the yen-dollar talks to improve residents' and nonresidents' access to Euroyen markets (see table 4). In July the Japanese press speculated that some of these measures would be implemented ahead of schedule to reduce economic tensions with West European countries and the United States.
- The rules governing Euroyen markets have been carefully crafted, however, to limit the markets' attractiveness. For example, Tokyo will not let proceeds from Euroyen CD issues flow back into Japan.

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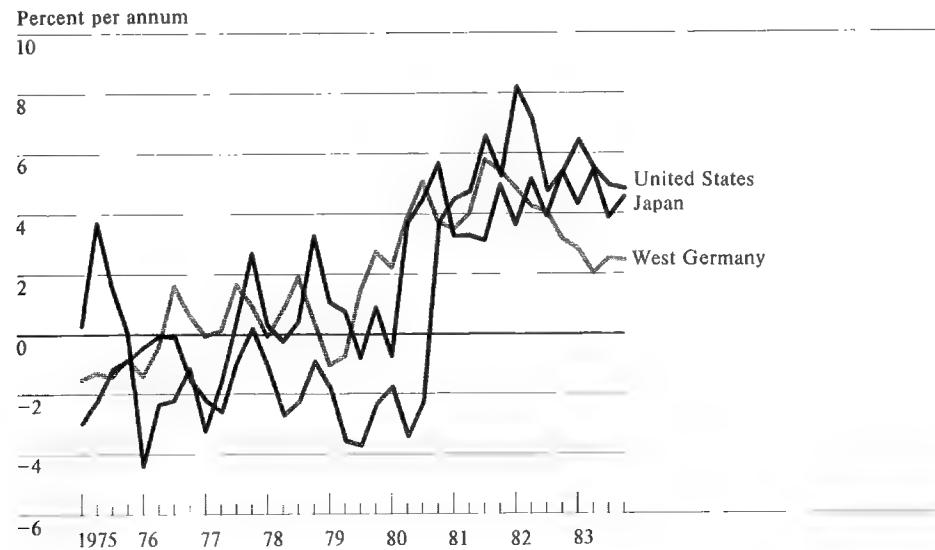
Figure 12
Selected OECD Countries: Short-Term
Interest Rates, 1975-84^a



^a Quarterly data.

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Figure 13
Selected OECD Countries: Short-Term Interest Rates
Adjusted for Inflation, 1975-83^a



^a Quarterly data. Adjusted using a nine-month moving average of the consumer price index.

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Implications of Financial Liberalization

Domestic Economic Ramifications of Liberalization

Analysts differ over how much future deregulation will impinge on Japanese interest rates and competitiveness:

- Some observers believe existing regulations insulate the Japanese financial system from international economic forces, permitting authorities to keep interest rates at artificially low levels. These analysts believe future deregulation will wipe out this artificiality, reducing Japanese competitiveness in the process.
- In our view, these arguments underestimate the effectiveness of past liberalization measures, particularly the deregulation of money market interest rates and the freeing of capital flows, at integrating Japanese financial markets with those abroad. Yen interest rates now generally move in tandem with those in other countries, especially during periods when Tokyo is trying to stabilize the value of the yen (see figures 12 and 13). We believe future increases in arbitrage involving Japan will be marginal compared with that which has already taken place.

Others point to increased funding costs for banks, resulting from deregulation of deposit rates, as another potential route to higher Japanese interest rates:

- Although we believe this argument has some merit, we also feel banks will be unable to pass along all their higher funding costs to corporate borrowers as deregulation spurs financial competition. Bank profitability is as likely to decline as corporate borrowing costs are to rise.

Data Resources, Incorporated (DRI) analysts contend a credit crunch is likely to strike Japan in 1985, magnifying the significance of any liberalization-induced rise in interest rates:

- These analysts see the combination of freer capital flows and a projected doubling of government bond issues beginning next year as leading to a 3-percent-age-point rise in government yields between 1984 and 1987.

- We disagree with this scenario, however, because most of the postulated increase in credit demand involves the refinancing of government debt that begins to mature next year. Tokyo's requirements for new money are actually declining.

Even if liberalization raises the cost of capital to some extent, we believe this development will alter Japanese competitiveness only slightly: 25X1

- As the share of Japanese corporate investment financed out of retained earnings has grown from 63 percent in 1968-73 to 75 percent in 1980-83, the potential competitive advantage conferred by low nominal interest rates has declined. Moreover, in real terms, interest rates in Japan are at unprecedentedly high levels and yet export competitiveness remains strong.

- The yen's current weakness against the dollar³ along with the country's skilled and diligent labor force are, in our view, more important than capital costs in explaining Japanese export competitiveness.

- If the analysts who believe a major interest-rate increase is in the offing are correct, the loss of Japanese export competitiveness would result mainly from the associated upward pressure on the value of the yen rather than from the increased financing costs of firms. The pressure on the currency, however, would have to be great enough to counteract the short-run negative effects past liberalization is exerting on the yen; these effects are described in the next section.

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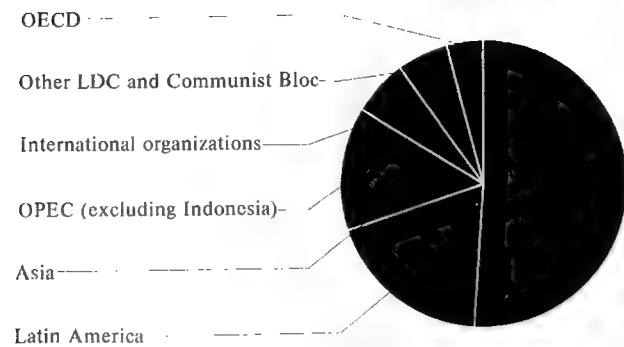
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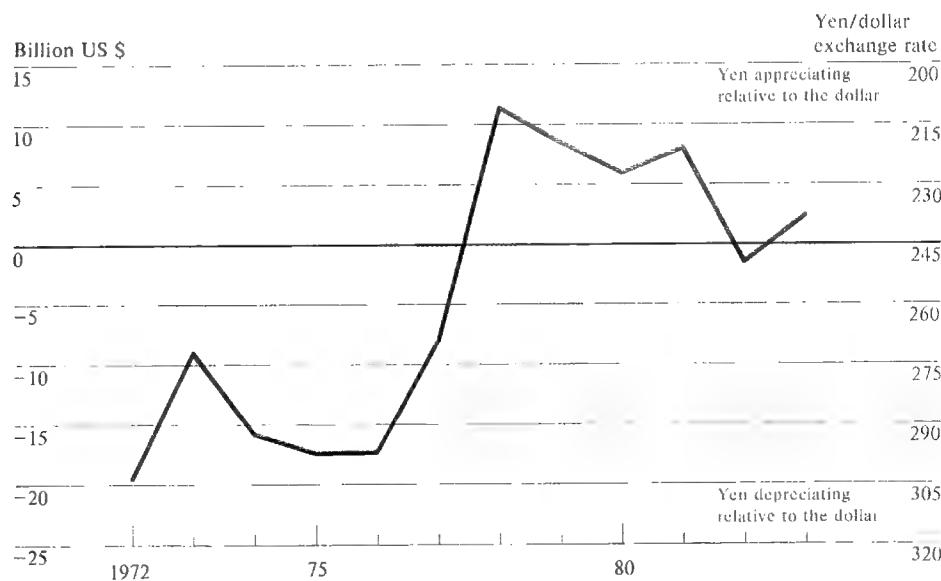
Figure 14
Japan: Medium- and Long-Term Loan Commitments to
Offshore Borrowers, 1982^a



^a Yen and foreign currency lending by private financial institutions totaled \$22.4 billion.

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Figure 15
Japan: Basic Balance and the Exchange Rate, 1972-83



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International Economic Implications of Deregulation

Financial liberalization in Japan has proved a boon to some foreigners and a headache to others. On the positive side, foreign access to Japanese capital markets—and thus to plentiful savings—has improved during the last five years, at least for many official borrowers:

- Eligibility requirements for foreign yen bond issues and loans have been eased repeatedly since 1981, when Japan's current account surplus began to mushroom.
- Yen markets in Japan cater primarily to sovereign borrowers. Not all foreign governments, however, enjoy equal access. We believe MOF decisions on which countries get priority in tapping yen markets are shaped largely by foreign policy concerns. At present, international organizations and ASEAN and West European countries appear the most welcome; troubled LDC debtors and Soviet Bloc countries appear the least welcome (see figure 14).
- Sovereign borrowers also obtain a large share of the syndicated offshore foreign currency lending done by the Japanese.

The downward pressure long-term outflows put on the yen is the negative side of the enhanced openness of the Japanese financial system. We do not, however, see a 1-to-1 correlation between liberalization and yen depreciation:

- Admittedly, annual changes in Japan's basic balance—the sum of the current account balance and the long-term capital account balance—and the yen-dollar exchange rate appear connected (see figure 15).
- We believe that much of the recent outflow facilitated by liberalization—and traceable to Japanese institutional investors—is a transitory phenomenon. Once the desired currency diversification of portfolios is attained, outflows should abate, reducing the downward pressure on the yen.

• Interest-rate differentials between yen and dollar assets play a much more important role in the size of capital flows, in our view, than specific liberalization measures do. These differentials stem primarily from dissimilarities between Japanese and US macroeconomic policy mixes and from dissimilarities in savings rates. Additionally, swings in the current account balance can swamp changes in the capital account balance.

• Over the longer term, liberalization is likely to help deepen Japanese financial markets; this should make them more attractive to foreign institutional investors, boost capital inflows, and perhaps raise the value of the yen.

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Continued liberalization of Japanese markets poses a potential challenge for Asian countries now serving as international financial centers, namely, Singapore and Hong Kong. Japan, with its high-savings rate and large economy, is in many ways a natural location for an international financial center:

- Although Japan has natural advantages, the limited English-speaking skills of its middle managers is a distinct handicap.
- Tokyo has not yet embraced the idea of becoming an international financial center, although Prime Minister Nakasone has voiced support for such a move. Concerns about the potentially harmful effects on neighboring financial centers partly explain the lack of enthusiasm among many government officials. Fears about the impact on domestic monetary policy formulation also play a role.
- Some Western analysts argue that the development of a successful Tokyo financial center would create more financial business for all of Asia rather than merely divert existing business to Japan.

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Figure 16
Japan: Corporate Financial Assets, 1975 and 1982

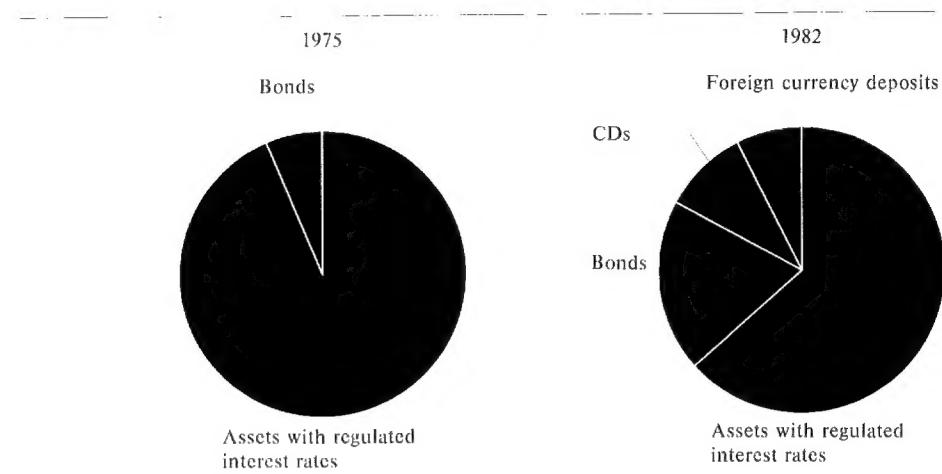


Table 5
Japan: Banks Among Top 50 Syndicated Loan Managers, Globally

1981		1982		1983	
Bank	Rank	Bank	Rank	Bank	Rank
Bank of Tokyo	14	Bank of Tokyo	4	Bank of Tokyo	6
Industrial Bank of Japan	19	Industrial Bank of Japan	13	Industrial Bank of Japan	12
Sumitomo Bank ^a	27	Fuji ^a	16	Fuji ^a	14
Fuji ^a	34	Sumitomo Bank ^a	20	Mitsubishi Bank ^a	17
Long-Term Credit Bank	39	Dai-ichi Kangyo ^a	25	Long-Term Credit Bank	24
Sanwa ^a	45	Mitsubishi Bank ^a	26	Sumitomo Bank ^a	25
Dai-ichi Kangyo ^a	49	Long-Term Credit Bank	27	Dai-ichi Kangyo ^a	26
Mitsubishi Bank ^a	50	Sanwa ^a	39	Sanwa ^a	28
		Nippon Credit Bank	45	Nippon Credit Bank	37
				Sumitomo Trust	40
				Mitsubishi Trust	47

^a Indicates city bank.

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Appendix

Japan: Chronology of Financial Liberalization Measures

		Event	Comment
1977	April	Underwriters allowed to sell government bonds after one year.	Increased link between interest rates in primary and secondary markets.
	July	Eurobond flotation by Japanese companies decontrolled.	Added to pressures on banks to look overseas for growth.
1978	June	Medium-term government bonds issued on auction basis.	Heightened market influence on terms of bond issues.
1979	May	Nonresidents allowed to participate in <i>gensaki</i> market.	Effectively linked Japanese money market with foreign money markets.
	October	Certificates of deposit (CDs) introduced. Rates on two-month bills allowed to move freely.	Spurred growth of underdeveloped money market. Ostensibly completed deregulation of money market.
1980	January	Investment trust funds in medium-term government bonds introduced.	Benefited small investors.
	December	New Foreign Exchange and Trade Control Law implemented.	Formalized new policy of permitting international capital flows.
1982	April	Tokyo Stock Exchange amends charter to permit foreign security companies to become members.	Of limited practical significance since there are only 83 seats on exchange.
		New banking law implemented.	Embody principle that foreign banks are to be accorded like treatment with domestic banks.
1983	January	Annual queuing system for issuance of yen bonds by foreigners replaced by quarterly system.	Facilitated recycling of growing current account surpluses.
	April	Banks allowed to sell newly issued long-term government bonds to public.	Heightened link between primary and secondary government bond markets.
1984	January	Minimum-size CD reduced to 300 million yen.	Boosted growth potential of money market by putting CDs within reach of more investors.
	April	Select Japanese companies allowed to issue Euroyen bonds.	Spur to internationalization of yen.
		Ended case-by-case screening of medium- and long-term yen lending abroad.	Expected to increase volume of such loans, even though prudential net worth ratios imposed.
	June	Select banks allowed to deal in government bonds with maturity of less than two years.	Further blurred lines between securities and banking activities.
		Ceiling for conversion of foreign currency into yen by banks abolished.	Simplified operations and widened financial base of banks, especially foreign ones.

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The Political Dimensions of Liberalization

We believe the political fallout from the liberalization of Japanese financial controls is likely to be as important as the economic fallout. Existing power relationships between the government and financial institutions, between financial and nonfinancial institutions, and among financial institutions are all likely to change.

Although we expect the Finance Ministry to retain greater control of financial transactions than its counterparts in other countries—if only by monitoring activities closely—the MOF's leverage over financial institutions will decline:

- Financial institutions still have an incentive to heed Ministry guidance, namely, to ensure themselves a voice in decisions concerning specific liberalization measures.
- As liberalization approaches its maximum level, however, we believe the Finance Ministry will find itself in the same position with respect to relatively sound financial institutions that the Ministry of International Trade and Industry finds itself in with respect to healthy nonfinancial corporations. Ministry advice will be respected only when it appeals to the self-interest of the institutions.

The supremacy of financial institutions over corporations is also likely to continue weakening, although less dramatically, in our view:

- A 1974 law, which prohibited banks from lending more than 20 percent of their capital and reserves to a single client, has already reduced the role played by main banks. These banks, usually city banks, act as advisers as well as bankers and spearhead financial rescue packages when necessary.
- Subsequently, Japanese companies made use of their new freedom in financial dealings to decrease further dependence on their main banks. Many firms now regularly tap nonbank and overseas funding sources and participate actively in Japanese money markets.

- The emphasis on trust and personal ties in business dealings in Japan has muted the impact of past liberalization measures. We suspect it will continue to do so in the future, preventing foreign financial intermediaries and the most competitive Japanese ones from quickly expanding their market shares.

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The power balance among financial institutions is also likely to shift, although the bottom line will depend heavily on the scope of liberalization:

- If product deregulation occurs in tandem with interest-rate deregulation, those institutions that now enjoy monopoly privileges in growth areas will be the losers. Examples are trust banks and insurance companies, which have exclusive rights to manage pension funds.
- On the other hand, if a high degree of specialization is maintained in the financial arena, the profitability and soundness of individual institutions will probably be jeopardized. Smaller banks are most vulnerable, and mergers may prove imperative.
- We believe the current heavyweights in Japanese finance (the large city banks and the four big securities houses) will fare well, regardless of the type of liberalization embraced. These institutions have aggressively internationalized their operations in the last five years and by so doing have learned how to compete in a market environment (see table 5).

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